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SENSITIVE
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TREASURY FOR M.NUGENT AND T.RAND
COMMERCE FOR 4430 BERLINGUETTE/KELLY
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SUBJECT: GOI Focuses on Policy Coordination In Bid to Reduce Impact of Growing Financial Crisis

¶1. (SBU) SUMMARY: A four-day local holiday beginning September 30 had insulated Indonesian markets from recent financial market volatility. On October 6, however, the main Jakarta Stock Exchange index sank 10%, the rupiah weakened by 1.5%, and domestic bonds sold off, causing a spike in benchmark 10-year domestic government bond yields to over 14%. As of late-day October 7, the stock market was down by another 1.75%, the rupiah finished flat following considerable volatility and government bonds fluctuated wildly , with ten-year yields moving from 12.1% to 14.7%, before closing at 14.256%. President Yudhoyono (SBY) convened a special meeting October 6 to discuss how Indonesia could reduce the impact of the growing financial crisis and respond to expected reduced demand from a slowing global economy. Following the meeting, the government of Indonesia released a statement announcing extension of tax incentives aimed at attracting additional investment. On October 7, Bank Indonesia continued to tighten monetary policy, raising overnight policy interest rates by 25 basis points for a sixth consecutive time (to 9.5%), in line with expectations. BI's decision followed release of September consumer price inflation data, showing the fastest inflation in two years (0.97% m-o-m/12.14% y-o-y), up from the pace in August and slightly above market expectations. END SUMMARY.

¶2. (U) Note: With financial markets gyrating, SBY named State Minister for State Enterprises Sofyan Djalil interim Finance Minister for ten days, beginning October 7, during Finance Minister Sri Mulyani's absence from the country due to attendance at upcoming World Bank/IMF meetings and a trip to the Gulf, where activities include a road show previewing Indonesia's planned global sukuk (shariah bond) issuance.

BI HIKES POLICY RATE AGAIN, CONTINUES MEASURED TIGHTENING
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¶3. (U) BI's latest hike should help to support the rupiah, as BI attempts to avoid sharp fluctuations in the exchange rate. The hike was welcomed by analysts, who had called for continued central bank

tightening to reduce strong domestic demand pressures which have fueled inflation. Many observers believe this may be the last in this series of rate hikes, as inflation is expected to begin trending down on lower energy and food prices. BI's October 7 monetary policy statement noted the decision had been taken after carefully considering recent financial and economic developments and their possible effects on the national economy. The statement further advised that going forward, Bank Indonesia will continue to coordinate with the government in assessing ongoing developments and taking necessary steps to maintain the sustainability and stability of Indonesia's financial system. The statement noted complete information about the latest economic conditions, including balance of payments information, would be included in BI's Monetary Policy Report, available October 14.

¶4. (U) Although the October 7 statement did not report gross foreign reserves as of end-September, the BI web site reported official reserve assets of $57.47 million (as of September 23), down from $58.36 billion at end-August, and foreign currency reserves of $54.9 billion, down from $55.9 billion at end-August. These declines came as BI reportedly intervened frequently, though selectively, in recent weeks to support the rupiah, which has fallen 2.3% in the past month. Indonesia remains vulnerable to sudden reversals in capital flows due to increased risk aversion. Bank Indonesia Governor Boediono told the press on October 5 that he believed most of the truly "hot money" had already exited Indonesia and that investors who remained are focused on Indonesia's economic fundamentals, which remain solid.

¶5. (U) Bank Indonesia's latest rate hike followed its decision on September 23 to extend the period of Fine Tune Operations, part of its Open Markets Operation, from a period of 1 to14 days to a period of 1 day to 3 months. This period extension provides BI with wider flexibility for liquidity management and may improve its effectiveness in maintaining a well functioning money market. Other regulatory issues, including possible changes in reserve requirements, reportedly remain under consideration.

INFLATION TICKS UP ON HOLIDAY SPENDING
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¶6. (U) September consumer price inflation released October 6 showed CPI running at a two-year high (0.97% m-o-m/12.14% y-o-y), and slightly above market expectations. The up-tick in inflation was expected, given increased demand associated with the Ramadan and Idul Fitri holidays. Raw food prices rose 1.9% m-o-m (20.12% y-o-y) and processed food rose 0.94% m-o-m (11.19% y-o-y). Housing and utilities rose 1.22% m-o-m (11.02% y-o-y), reflecting in part the effect of LPG price hikes made in July and August.

TRADE BALANCE IMPROVES, AS IMPORTS FALL
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¶7. (U) August trade figures released October 6 show continued strong economic activity and an improved trade balance, with the trade account moving back to surplus following July's trade deficit. While exports declined by 0.4% m-o-m in August (to $12.5 billion), they rose by 30.3% y-o-y. Declining commodity prices contributed to the slight monthly decline in exports, but crude palm exports rose strongly (to $1.03 billion, from $581.6 million in July) on higher volumes as the GOI cut export taxes. Total imports fell 7.5% m-o-m to $11.86 billion, but imports outside the free-trade zones rose 55% y-o-y.

EFFORTS TO DEAL WITH MARKET VOLATILITY INCLUDE
TEMPORARY BAN ON SHORT SELLING
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¶8. (U) The volatility which hit the Indonesian Stock Exchange, whose main index fell more than 10% (to 1,648.74) on October 6, followed a 4-day holiday closure from September 30 through October 3. The Indonesian Stock Exchange had announced September 30 the imposition of a temporary ban on short selling for the month of October. The Exchange has lost more than 35% from its January 14 high as lower commodity prices and greater risk aversion have reduced demand for emerging market equities.

SBY ENCOURAGES A MORE COMPREHENSIVE RESPONSE
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¶9. (U) As volatility has increased in international financial markets, the Yudhoyono administration has begun to mobilize efforts across government agencies. SBY has reached out to the private sector and large state-owned enterprises to contribute to a more comprehensive response aimed at maintaining economic growth of at least six percent. This wider engagement should augment the continuing close collaboration between the Ministry of Finance and Bank Indonesia.

¶10. (U) On October 6, SBY convened a special plenary meeting of ministers, BI, and leaders of state-owned enterprises (SOEs), the banking community, and representatives of the private sector, academicians and the media to discuss Indonesia's response to the growing crisis in international financial markets. SBY noted Indonesia was in a much better position to face this crisis than it had been ten years ago and highlighted greatly improved political and economic stability. SBY outlined ten instructions focused on the united effort needed to manage and overcome the effects of the current financial crisis on Indonesia. A central aim is to maintain economic growth of 6%. SBY said this will require the concerted efforts of the government, BI and the private sector. These efforts

will include the guarantee of credit and liquidity, improvements in regulatory policy, the investment climate and incentives aimed at assisting the real sector to continue moving forward, and a campaign to promote consumption of domestic products. SBY also stressed that the state budget should be optimized to spur economic growth, build a social safety net, increase efficiency, and limit consumption spending and discretionary spending that could be delayed. He also noted that Indonesia must also take advantage of opportunities for trade and economic cooperation with other countries.

GOI TO OFFER INCENTIVES TO ATTRACT INVESTMENT
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¶11. (U) On October 6, the government of Indonesia announced issuance of a new government regulation (no. 62/2008, revising regulation no. 1/2007), which will offer additional incentives to attract investment. These incentives focus on expanding the number of sectors and local areas in which firms may invest and enjoy a lower income tax rate for up to six years (a reduction in net income of up to 30% of capital investment, over six years for up to 5% each year); accelerated amortization; a 10% income tax on dividends paid to foreign tax entities and favorable treatment of losses (in years 5 through 10 of the investment). Firms investing in specified sectors (including steel, forestry, geothermal, animal husbandry, coal mining, textiles, pulp and paper, oil refining, small-scale gas liquefaction, chemicals, agriculture, automotive parts, and electronics) will enjoy these benefits.

Efforts to Reduce Budget Deficit, Seek
Alternative Sources of Financing
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¶12. (U) As the global credit crunch has driven up the costs of financing and of insuring against credit defaults, the Ministry of Finance has sought to ease financing requirements. Finance Minister and Coordinating Minister for the Economy Sri Mulyani Indrawati has made a number of statements outlining her interest in limiting the 2009 budget deficit to 1.5% of GDP, below its previous target of 1.9% of GDP, and the possibility that the 2008 budget deficit may fall even further from a recently revised figure of 1.7% of GDP (vs. the original target of 2.1% of GDP), presumably as non-essential spending is deferred. Sri Mulyani has also advised that the government would attempt to finance a larger portion of the budget deficit from bilateral borrowing rather than capital markets, although the government currently plans to move forward with its first global sukuk issuance later this year.

ENCOURAGING REPATRIATION OF FUNDS
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¶13. (U) According to press reports, the State Minister for State-Owned Enterprises, Sofyan Djalil, urged SOEs with off-shore foreign currency deposits in excess of specific needs to transfer

those funds to the domestic banking system. Djalil said companies such as Pertamina, Telkom, PLN, Aneka Tambang, Perusahaan Gas Negara and Timah should not park funds off-shore when Indonesia needed additional foreign currency.

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